Chapter 20

Billing Rates — Sole Proprietor and Partnerships

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General

For most firms, billing rates are usually pre-established and published hourly rates charged to most of their clients. Sometimes these rates vary depending upon the type of work to be performed or are based on “the going rate” or on what “the market will bear.”

When preparing cost proposals for WSDOT, the firm’s billing rates must be calculated in a different way.

Billing rates accepted by WSDOT are made up of three components.

Hourly Pay Rate

First is the individual employee’s hourly pay rate. This rate usually will be the same rate as shown on the employee’s payroll records and in his/her personnel file. The WSDOT auditor will review the company’s payroll and personnel records to verify the employee’s actual pay rate.

Application of an Overhead Rate

Second is the application of an overhead rate. The WSDOT auditor will calculate the accepted overhead rate based upon the firm’s stated overhead rate as adjusted to comply with 48 CFR 31, WSDOT Cost Principles, and WSDOT Travel Directive D 13-50. This rate is calculated by dividing the adjusted overhead costs by the adjusted direct labor. (To accomplish this, the auditor will need to review, for the audit period, the firm’s time sheets, monthly and/or quarterly and/or annual time and payroll summaries, vendor files, tax records, general ledger, trial balance, income statement, and balance sheet.)

Fixed Fee

Third is the profit rate or fixed fee to be allowed. This is determined in one of two ways. A profit percentage can be applied to the direct labor rate. This is a negotiated rate between the firm and the negotiating officer. The rate usually ranges between 17 and 35 percent of direct labor depending upon the size, difficulty, and complexity of the agreement, the extent of supervising subconsultants, etc.

The other method is to negotiate a fixed dollar amount for profit. A percentage of the profit amount is then billed each month to equal the percentage of the job completed.

Billing Rate

All three of the above factors are then added together to arrive at an individual's billing rate. This rate is then applied to every hour which that employee works on the WSDOT project.

Some agreements may not list individual employees' billing rates, but instead may list billing rates by classes of employees such as principals, senior engineers, engineers, drafters, etc. In this case, billing must still be based on actual payroll rates for each employee. WSDOT does not allow the use of average rates.

Some employees may actually earn less than the agreed upon rate, while others may earn more. For this type of agreement, it will be necessary for the WSDOT auditor to verify that the employees being billed in a specific class are actually classified as such and are being paid accordingly.

Rate Adjustment

Proposed, projected, and approved billing rates may be adjusted, depending upon the language of the agreement.

Part-Time Employees

Part-time employees who do not receive all of the firm's fringe benefits should be using a lower billing rate than the full-time employees as the overhead costs associated with them are less than with the full-time employees. If the firm has a 30 percent benefit package and an accepted overhead rate of 150 percent, then a part-time employee who receives no benefits should be using an overhead rate of 120 percent when calculating his/her billing rate. The profit rate remains the same.

Contract Labor (Employees)

Hours for independent contractors and contract employees (those hired through an employment agency or independently), are not to be included with the firm's employees when invoicing WSDOT. These workers should be billed to WSDOT at the actual cost to the firm (with no markup) under the direct nonsalary costs section of the invoice. Also, payments to independent contractors and contract employees are to be excluded from the direct labor base used in calculating the firm's overhead rate.

Sole Proprietors' and Partnership's Wage Rates and Billing Rates

A sole proprietorship is a company owned by one person. For tax purposes, the company's net profits become the proprietor's or partner's taxable income, and the company's net losses become the proprietor's net loss for tax purposes.

For WSDOT purposes, there are several ways to look at calculating gross wages, hourly pay rates, and billing rates.

Gross Wages

Gross wages should at least be equal to the net income shown on the individual's tax return. But other items may have to be added to the net income or draws when calculating the individual's gross wages for WSDOT purposes. Auto allowance, insurance premiums, retirement plans, savings accounts, investments, meals, and other similar expenses are some examples. Where larger companies include some of these as employee benefits in the overhead, a sole proprietorship or partnership may have to include them in their gross wages.

Auto allowance is taxable to the individual to the extent that receipts are greater than expenses incurred. The amount allowable for overhead is the amount attributable to the business, either actual or percentage wise. Properly documented mileage reimbursements are not taxable, but are totally included in overhead.

Insurance and retirement plans are legitimate business expenses provided that they are not excessive in amount and the business is not the beneficiary.

Savings and investment accounts are taxable income to the individual for the amounts deposited during the current year plus the interest earned during the year.

Meal expenses are business expenses only to the extent that they are truly business related. Everyday breakfast, lunch and/or dinner costs are not business related and should be taken out of overhead and added to the individual's income.

In summary, gross wages for a sole proprietor should include all income taken plus the value of any expenses which directly benefit the owner over and above the normal business amount.

Hourly Rates

Sole proprietors usually bill a predetermined hourly rate. This rate is usually as high as the owner feels is reasonable or all that competition will allow based on competitive pricing.

For small businesses, competition and seasonal workloads are crucial to their survival. Their rates may generally go up and down depending on the workload at the time they are bidding a job. If they have little or no work, they will usually lower their rates to a point that will cover their costs but allow nothing for salary or profit.

One method of calculating an hourly rate for the labor distribution of the sole proprietor is to take their gross wages and divide them by the actual number of direct and indirect hours worked to arrive at an hourly rate. Then multiply the hourly rate times the direct and indirect hours to get the direct and indirect labor.

A different method is to take the total dollars billed and divide by the billed hours. This hourly rate times the number of hours billed will equal the direct labor costs. The owner's gross wages minus the direct labor leaves the amount to go into indirect labor.

We may calculate the hourly rate as above, multiply the direct hours times the hourly rate to get the direct labor and multiply the indirect hours times the rate to get the indirect labor. All gross wages over the calculated direct and indirect labor are dropped from the labor base calculations entirely.

If the agreement is to be a cost plus agreement, then the billing rate would be the same as the hourly rate as calculated above. If the agreement is to be all-inclusive hourly rate, then the firm's overhead rate will need to be calculated, as discussed above, and, along with the negotiated profit rate, added to the hourly rate as calculated above. This becomes the sole proprietor's or partner's billing rate.

As you can see, there are many variables to be considered when calculating the worth of an owner to the business entity. Here, we have presented some of them for your consideration. Since there are no existing guidelines as to how we will treat sole proprietors and partnerships, we will make no recommendations, but allow management to decide how they will be treated for WSDOT overhead calculations.

The reader is directed to Chapter 19, which discusses the development of the sole proprietorships billing or salary rate, including the firm's overhead rate.

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